

Aid Can Be the Midwife of Good Policies

SOUND MANAGEMENT THAT PRODUCES MACROECONOMIC stability, openness, rule of law, and absence of corruption leads to growth and poverty reduction. It also creates the right environment for aid to reduce poverty. While a \$10 billion increase in aid could lift 25 million people out of poverty each year, an even bigger assault on global poverty will require further institution building and policy reform. Between the mid-1980s and mid-1990s there were huge advances in the quality of management in developing countries. A further improvement of the same magnitude could add a full percentage point to developing country growth and lift another 60 million people a year out of the poverty abyss. Policy reform and capacity building are the keys. Ideas and money—together—have the potential to do far more than finance alone.

In this chapter we review the relationship between aid and policy reform at the macroeconomic and sectoral levels. Has the amount of finance that countries receive affected their policies? Some conservative critiques of aid hold that finance will lead to poor policies. What is the evidence? We also examine policy-based (or conditional) lending and the extent to which it has helped improve economic policies in developing countries. Then we focus on less tangible mechanisms through which aid can affect policy—dissemination of ideas, education of future leaders, stimulation of policy debate within civil society. Arguably, this is one of the most important roles for aid.

It is hard, however, to make generalizations about aid and policy. First, it is not true that countries that receive large amounts of aid have bad policies; there is surprisingly little relationship between the amount of aid and policies. Second, policy-based lending has a mixed record. Many societies have initiated serious reform programs, and adjustment lending has been

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successful in supporting those reforms and helping lock in policy gains. At the same time there is a long legacy of failed adjustment lending where there was no strong domestic constituency for reform. Foreign aid cannot take the lead in promoting reform if there is little local movement in that direction. Finally, and somewhat speculatively, case studies suggest that aid can play an important role in stimulating reform over the long haul. Foreign aid has helped finance the overseas education of many leaders, an investment that may not have much effect on policies for 20 years or more. There are also cases in which foreign assistance has stimulated policy debates within civil society, but it is difficult to measure the impact.

Conditional lending is worthwhile where reforms have serious domestic support. As with aid in general, however, donors have not been sufficiently selective with policy-based lending. In countries with poor policies and no movement toward reform, it is worth thinking about how to create reformers and popular movements for reform, but it will not be easy. Adjustment lending has not been a useful tool in this respect, and may have been counterproductive. The role of aid in difficult environments is to educate the next generation of leaders, disseminate information about policy, and stimulate public debate where possible.

Money—Good or Bad for Reform?

SOCIAL SCIENTISTS HAVE LONG DEBATED THE ROLE OF OFFICIAL AID in supporting reform. If policy reforms have short-term costs affecting particular segments of the population, foreign aid can help get those reforms off the ground. Stabilization typically requires fiscal adjustments that lead to higher taxes or fewer services for some groups. Trade liberalization hurts firms and workers in previously protected industries. State enterprise reform and privatization often lead to transitional unemployment. If a government wants to implement these reforms, foreign aid can help with adjustment costs.

One recent study analyzed eight major postwar economic reformers: Bolivia, Chile, Germany, Israel, Mexico, Poland, and Turkey (Sachs 1994). In each case aid was a crucial contributor, though all governments were committed to reform before large-scale aid arrived. The study concluded that aid helps “good governments to survive long enough to solve problems” (p. 512). Moreover, foreign aid increases the effect of policy

reform on growth, thus raising benefits relative to costs. This should increase the likelihood that reform will be sustained.

Another study, however, points out that “aid can also help bad governments to survive” (Rodrik 1996). “For debating purposes, one can cite at least as many cases as Sachs does to demonstrate an association between plentiful aid and *delayed* reform One of the pieces of conventional wisdom about the Korean and Taiwanese reforms of the 1960s is that these reforms took place in large measure because U.S. aid, which had been plentiful during the 1950s, was coming to an end” (p. 31).

Burnside and Dollar examined the relationship between aid and their index of macroeconomic and trade policies for the 56 countries in their sample. They showed first that policies can largely be explained by underlying country characteristics, such as the rule of law, ethnic splits (which are associated with poor policies), or political instability (also linked to poor policies). When aid is added to this analysis, it has no effect on the policy index. This does not refute Sachs’s view that aid contributed to reform in some cases—instead, it shows only that aid supported governments with bad policies to about the same extent that it supported reforming governments.

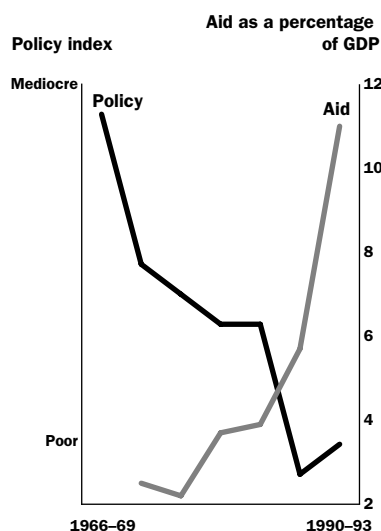
While there is not much relationship between the amount of aid that countries get and the *level* of their policies, it is still possible that aid supports changes in policies. If donors were good at anticipating “turning points” and at increasing their aid *just before* reform, we would observe aid flowing to poor policy regimes, but the flows would be followed by reform. Alesina and Dollar (1998) investigate this possibility. In a sample of 60 countries, they identify 87 episodes in which there is a surge in aid (a large change relative to what the country had been receiving). In only six of the 87 episodes was the surge followed by significant reform. In 92 cases in which there was a large decline in aid, 16 were followed by reform. Thus, reform is more likely to be preceded by a decline in aid than an increase in aid. But the main thing that emerges from this work is that there is little relationship between changes in aid and policy reform. It is not generally the case that donors have successfully anticipated “turning points” and increased their assistance in advance of reform.

The varied relationship between aid and policy can be seen in individual countries. Zambia, for example, could support the view that aid enables governments to delay reforms. Policies in Zambia were poor and getting poorer throughout 1970–93, yet the amount of aid that it

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In Zambia, policies got worse while aid increased . . .

Figure 2.1 Zambia: Aid and Policy



Source: Dollar and Easterly 1998.

received rose continuously—reaching 11 percent of real GDP by the early 1990s (figure 2.1).

For every Zambia, however, there is a Ghana. Ghana received little aid when it had bad policies—but has received strong donor support since it reformed (figure 2.2). Case studies of Ghana generally find that foreign assistance helped consolidate a good reform program. In Burnside and Dollar's 56 country sample, these different experiences cancel out: aid and policy are virtually uncorrelated. When other variables known to affect policy are introduced, there is still no relationship between aid and policy.

So, there is no simple relationship between the amount of aid that countries receive and the quality of their policies. Aid may still have contributed to policy reform in some cases, however, either through the leverage of conditionality or through the dissemination of ideas.

Ownership—What Money Cannot Buy

IF AID IS AS LIKELY TO DELAY REFORM AS ENCOURAGE IT, WHY NOT make assistance conditional on policy reform? After all, financial support from the International Monetary Fund and structural adjustment lending from the World Bank are designed to disburse only as reform measures are carried out. Although these flows are only a fraction of official finance, other donors pay attention to structural adjustment programs when making decisions about aid allocations.

For various reasons, however, conditionality may fail to generate permanent improvements in policy. First, it is inherently difficult to monitor. Take, for example, a seemingly simple condition: that the fiscal deficit not exceed a certain level. The fiscal deficit is influenced not just by government policy, but by shocks outside government control. So a country may miss an agreed target because of a shock; in fact, doing so may be desirable because a target that is good policy in one environment becomes poor policy in another. Whether or not a policy target has been met requires some subjective judgment. The subjectivity becomes more acute as reforms become more complex institutionally.

The second problem with conditionality is that it has force only during the life of the adjustment program. A government in financial difficulty may agree to reforms and carry them out to obtain conditional

resources. If there is no strong commitment to these reforms, they can — and likely will—be reversed at the end of the program.

The third and probably most serious problem concerns incentives within donor agencies. Disbursing funds is one of the important rationales for these agencies. Since monitoring policy reform requires some subjective judgment, donors will likely find that governments are making a good effort—whether they are or not—and disburse their funds. *The Economist* describes this kind of donor behavior as follows:

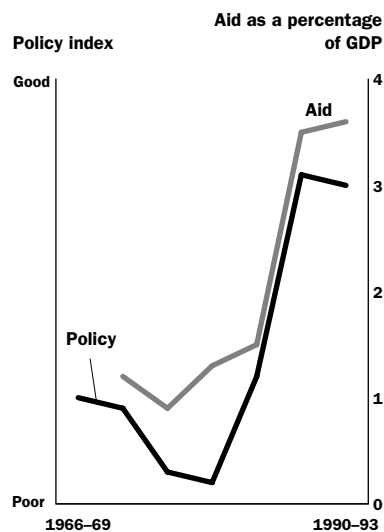
“Over the past few years Kenya has performed a curious mating ritual with its aid donors. The steps are: one, Kenya wins its yearly pledges of foreign aid. Two, the government begins to misbehave, backtracking on economic reform and behaving in an authoritarian manner. Three, a new meeting of donor countries looms with exasperated foreign governments preparing their sharp rebukes. Four, Kenya pulls a placatory rabbit out of the hat. Five, the donors are mollified and the aid is pledged. The whole dance then starts again” (August 19, 1995, p. 37).

There is a mountain of literature on structural adjustment lending and its effect on policies (for example, Mosley 1987, Mosley and others 1995, and Thomas 1991). All the studies conclude with skepticism about the ability of conditionality to promote reform in countries where there is no strong local movement in that direction. One concludes that, in Africa, structural adjustment lending from the World Bank affected the policies of recipients “a little, but not as much as the Bank hoped” (Mosley and others 1995). The main problem was that the World Bank had strong incentives to disburse funds—and thus was inclined to see a good effort even where there was none. In fact, in the authors’ sample of adjustment loans, only 53 percent of loan conditions were met. Even so, almost all adjustment loans were disbursed. Zambia, for example, received 18 adjustment loans between 1966–69 and 1990–93 while its policies got worse (see figure 2.1). In Kenya the World Bank provided aid to support identical agricultural policy reforms five separate times. Each time reforms were either not implemented or later reversed. Yet all adjustment loans were disbursed. The lesson? A conditional loan is no guarantee that reforms will be carried out—or last once they are.

Yet, adjustment lending from the IMF and the World Bank has supported many successful reform programs. Bolivia is a good example of a

. . . but in Ghana, aid rose in lockstep with better policies.

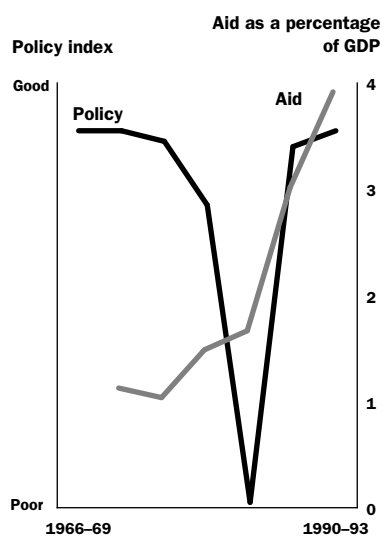
Figure 2.2 Ghana: Aid and Policy



Source: Dollar and Easterly 1998.

In Bolivia, adjustment lending provided finance to a determined reforming government.

Figure 2.3 Bolivia: Aid and Policy



Source: Dollar and Easterly 1998.

country where adjustment lending provided finance to a determined reforming government, with assistance increasing in lock-step with policy reforms (Lopez 1997; figure 2.3). Much of this increase in finance came through adjustment loans. Another review of policy-based lending concluded: "It seems clear that the lending cum conditionality process works well only when local polities have decided, largely on their own, possibly with outside technical help, to address their reform needs, effect certain policy changes sequentially, and approach the international community for financial help in getting there" (Ranis 1995, p. 10).

In its own internal reviews the World Bank has come to the same conclusion—"ownership," or strong domestic support of reforms, is essential for adjustment lending to succeed. Before 1990 about a third of adjustment loans failed to achieve expected reforms, and the lack of borrower ownership or commitment was a key factor in the failures (Branson and Jayarajah 1995).

In a sizable sample of World Bank adjustment loans (105 cases where reforms were successfully carried out, and 55 where they were not), a recent study found several political and institutional features associated with successful reform programs (Dollar and Svensson 1997). Most important, 52 percent of governments that implemented successful reforms were democratically elected, whereas only 29 percent of governments overseeing failed programs were democratically elected. Governments that had been in power for a long time were less likely to implement reform successfully. Furthermore, political instability was highly correlated with failure (table 2.1). Political and economic variables successfully predicted the outcomes of 75 percent of the adjustment loans (appendix 2).

Table 2.1 Features of Successful and Failed Adjustment Programs

	<i>Successful</i>	<i>Failed</i>
<i>Country statistics</i>		
Democratically elected	52%	29%
Government crisis during reform period	9%	24%
<i>World Bank variables</i>		
Preparation (staff weeks)	143	135
Prior analytical work (staff weeks)	84	80
Number of conditions	45	47
Loan size (millions of U.S.dollars)	169	166

Source: Dollar and Svensson 1998.

The study also examined factors under the World Bank's control, including: size of the adjustment loan, number of conditions, resources used to prepare the loan, and resources devoted to analytical work in the four years prior to the loan. It found that these "Bank effort" variables are similar for successful and failed adjustment programs (see table 2.1). When all the variables are tossed into the analysis, it becomes clear that successful reform depends primarily on a country's institutional and political characteristics.

In the past the World Bank did not sufficiently take into account that success or failure of reform depends largely on a country's own effort. A case in point: Zambia. In the 1980s the Bank approved four structural adjustment loans totaling \$212 million, and they were almost fully disbursed. After completion, the World Bank rated three of the four loans as failures: that is, reforms supported by the loans were not satisfactorily implemented. The Dollar-Svensson results suggest that this was largely predictable. Conditions in Zambia at the time were not conducive to reform. The government, not democratically elected and in power for a long time, was likely a nonreformer. It may have been worth taking a chance on the first adjustment loan, but (admittedly with 20/20 hindsight) a succession of policy-based loans for Zambia was not the best use of resources. Donors have gradually learned this lesson and become more selective about providing policy-based assistance. In 1990–95, the success rate of World Bank adjustment loans increased to 76 percent (World Bank 1997a).

These studies suggest that policy reform depends largely on countries' institutional and political features. Borrower ownership of reform is increasingly recognized as a prerequisite for success. But once a serious reform program is started, financial assistance can help consolidate it.

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Fomenting Reform

EMPIRICAL LITERATURE HAS SHOWN THAT REFORMS WITHIN reach for low-income countries could add 2–3 percentage points to their growth. Given that long-term growth has been zero to 1 percent per capita for most of these countries, that would be a huge improvement. For many of the poorest countries—those that are falling further behind in relative terms—initiating serious policy reform is

perhaps the most important issue on their agenda. At the same time, it is not easy to generate reform, and conditional lending into weak institutional and policy environments has failed. So, can donors promote policy reform in the highly distorted environments of, for example, Myanmar, Nigeria, or the Democratic Republic of Congo? Or do they simply throw up their arms and walk away?

Clearly, to desert difficult countries is unacceptable. As poverty is reduced in developing countries with sound policies, countries with highly distorted policies will account for an ever-increasing share of the poor. What is the answer? There is evidence that donors can make a difference without large-scale financing. Intangible and low-cost efforts can promote policy reform over the long term—by disseminating development ideas, training the next generation of leaders, and stimulating policy debate in civil society.

Development agencies have played an important role in disseminating information about what is good policy, both at the macroeconomic level and in individual sectors such as education, health, and pension reform (box 2.1). But good policy is not something subjectively decided by the World Bank; lessons emerge from the experiences of developing countries. Good management is, objectively, what has increased growth and reduced poverty in those countries.

Some key development policies (macroeconomic stability and openness) have become known as the “Washington consensus.” This is an ironic designation because in the 1970s agencies such as the World Bank were not promoting these policies. In fact, the Bank was taken

Box 2.1 Reforming Pension Schemes

MANY DEVELOPING AND TRANSITION ECONOMIES have unsustainable public pension schemes—that is, pay as you go schemes that function as long as there are lots of workers and few retirees, but become unworkable when there are more retirees than workers. A World Bank report, *Averting the Old Age Crisis*, and its follow-up dissemination and technical assistance are a good example of how low-cost assistance can stimulate policy reform. Following the report, donors have helped many countries study the long-term fiscal and distributional consequences of

their old-age security—Argentina, China, Hungary, Mexico, Poland, and Uruguay, for example. Officials involved in successful pension reform—in Chile, for instance—have been used to disseminate important messages. The thrust of technical assistance has been to help countries simulate the effect of their current pension systems and reform alternatives. In many cases these analyses have become a platform for public debate on pension reform and a way for the government to convince the public that reform is necessary.

with statist policies, such as those of Julius Nyerere in Tanzania. Through experience, however, the world has learned that this approach does not lead to sustained development. At the same time such policy-makers as T.S. Chiang and T.C. Liu in Taiwan (China) were experimenting with policies that were not in fashion with the international development community.

It was only in the early 1980s that development agencies started to appreciate fully the value of sound macroeconomic management and began to promote trade liberalization and encourage closed economies to learn from the success of more open ones. It is hard to assess the impact of this dissemination of ideas. Sachs and Warner (1995) identify 35 countries that liberalized trade in the past 10 years. These countries almost certainly were influenced by past successes in other countries. Did development agencies play an important part in disseminating knowledge about successful policies? Likely, yes—but it cannot be proved one way or another.

Development assistance can also promote dissemination of knowledge about development by funding programs to send students abroad—to study economics, law, public administration, and so on. Returning students often play a key role in policy reform—either directly as government employees or officials or indirectly through work in domestic universities and the media. One famous example is the Berkeley group that designed Indonesia's reform in the late 1960s and early 1970s. Over the past 10 years many reforms in Latin America have been designed and implemented by ministers who studied economics abroad. In Botswana the U.S. Agency for International Development had a long-standing program that trained most government officials.

One study of the political economy of reform concluded that few generalizations could be made about successful developing country reform (Williamson 1994, p. 589). Of critical importance was a "coherent economic team." In most cases key members of economic teams in reforming economies have at least some overseas economics training, usually supported by donors or by nongovernmental organizations, such as the Ford Foundation.

Overseas training is not, however, a panacea for reform. Instead, where other domestic political factors have started a reform movement, well-trained economists and civil servants are crucial for its success. There are also many cases where people have been trained but not put to effective

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use. A recent study of aid in Africa by the Overseas Development Council includes both successful and unsuccessful examples:

Master's level staff in government earn a fifth of what they could earn working for one of Nairobi's international management consulting firms.

“Governments find it difficult to retain qualified staff because of internal management problems and low wages in the public sector. At independence, civil service salaries were typically much higher than salaries in the private sector. . . . In the Tanzania and Kenya of 1970, for instance, a government worker earned 14 and 11–16 percent more, respectively, than a private sector employee with the same experience and education. By the late 1980s, however, reckless patronage practices, along with inflation and persistent fiscal crisis, had devastated individual salaries. In Tanzania, the number of civil servants had increased from 135,000 in 1970 to 302,000, but civil service salaries had lost 94 percent of their former purchasing power African governments found it difficult to retain competent staff, particularly at higher grades and technical levels. Thus, one study describes a CIDA-funded project in Kenya that trained 13 economists to master's level between 1985 and 1991; within a year, ten had found jobs outside of government and the other three, freshly returned from Canada, were looking for better paid positions in the private sector. The problem is simply that master's level staff in government earn a fifth of what they could earn working for one of Nairobi's international management consulting firms or the resident mission of a donor agency.

“The most able often leave: across Africa, civil servants have accepted better-paid jobs in the private sector or migrated out of the country. According to the United Nations, some 50,000 to 60,000 middle and high-level African managers left their country of origin between 1986 and 1990. Many went to work for the aid agencies themselves, lured by salaries often five to ten times higher than in the public service. In Kenya, for instance, a World Bank project hired eight Kenyans for a project it was financing in the Ministry of Agriculture, paying them between \$3,000 and \$6,000 a month compared with a total compensation package of approximately \$250 available to a senior economist in the civil service.

“In a country like Botswana that avoided economic crisis, the presence of a virtuous cycle results in a very different dynamic. Regularly paid and given the means to perform their jobs, civil ser-

vants stay in their positions. It is not unusual for a permanent secretary to remain in the same position for more than ten years. Although private sector wages have increased recently and some employees have left the civil service, few have left the country. The case study reports USAID's claim that all but three of the 1,300 or so Botswanans who have received master's level training in the United States since independence have returned to the country" (van de Walle and Johnston 1996, p. 89–92).

Clearly, well-trained officials can be an important input to good policy (witness Botswana). If other factors conspire to maintain poor policies, however, trained officials are likely to leave the public sector (though they may still make a big contribution to development). But they often emigrate, in which case training will not have provided the intended benefits to the country.

Stimulating debate in civil society about policy is an intangible way for development assistance to influence policy reform. This is not easy. Leaders in countries with poor policies have interests in maintaining those policies. Highly distorted trade regimes, exchange rates, and agricultural prices, for example, can lead to corruption and rent seeking among favored groups. In such cases donors should look for space to develop a dialogue with the middle civil service—usually more technocratic than political—and with elements of civil society.

In Ukraine, for example, during an era of poor policies, the World Bank decided that lending would be counterproductive. It would postpone reforms even further, and other interventions were needed—for example, public education for the government and civil society. The media, reformers within government, parliamentarians, nongovernmental organizations, and the private sector were involved in major seminars, nationwide town meetings, and a weekly, high-profile roundtable with the media on key economic and institutional reform issues. One champion of this program was the governor of Ukraine's central bank, who participated actively and remarked publicly that the most important things that the World Bank did in early transition to help promote reforms and development were to refrain from large-scale lending and implement the public education program.

There are few hard research results to show that disseminating good ideas, sending students abroad, or stimulating policy debates in civil society leads to developing country policy reform and better performance.

Stimulating debate in civil society about policy is one way for development assistance to influence policy reform.

But case studies suggest that these factors are often important. Moreover, such activities are inexpensive.

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If Commitment, Money—If Not, Ideas

THERE IS NO VALUE IN PROVIDING LARGE AMOUNTS OF MONEY to a country with poor policies, even if it technically commits to the conditions of a reform program. Providing adjustment loans to governments not serious about reform has been a major recent problem of foreign aid.

For many low-income countries, initiating economic reform is crucial for future progress. But it is not easy for outsiders to generate reform. In countries with poor policies, donors should concentrate on activities that might support reform in the long run—overseas scholarships, dissemination of ideas about policy reform and development, and stimulation of debate in civil society. In most cases these are relatively low-cost measures, so there is no contradiction with the strong message that most finance should go to poor countries that have made substantial progress with policy reform.

Our review also found that adjustment lending is most effective if a government is strongly committed to reform. This raises a question, however: if reform programs must have strong domestic support to succeed, is there any point in having conditional lending? One study argues that there is still a useful role for policy-based lending, but that the way that it is managed must be reformed (Collier 1997). In the past donor agencies have tried to “buy reform” by offering assistance to governments that were not otherwise inclined to reform. This approach failed. Moreover, this use of conditionality undermines its potential value. Governments truly committed to reform may agree to a conditional loan that binds them to a policy and protects them from internal special interests. Such a conditional loan is a type of restraint that helps government resist the temptation to deviate from good policy in the pursuit of short-run interests.

Conditional loans can also be useful as signaling devices. Uncertainties about policy retard investment. Conditional loans can indicate to the private sector that government is serious about reform and the new policy regime is likely to persist. In good-policy countries, aid is associated with higher private investment; the combination of reform and foreign assis-

tance can boost investor confidence. Collier points out that the way in which policy-based lending has been managed tends to undermine its usefulness as a restraint and signaling mechanism. These loans have not been useful as restraints (since funds have been disbursed regardless of whether reform has been carried out) and have not been good signals of the seriousness of reform (before 1990 one-third of adjustment loans failed).

The role of agencies such as the World Bank is not to arm-twist governments to do what they are reluctant to do. Nor is it true that if the World Bank works harder or puts more resources into an adjustment loan, a failed reformer can somehow be turned into a successful one. Instead, the role of international institutions should be to disseminate information that might influence public dialogue about policy reform—and to learn to read the signals about whether governments are serious or not. Mistakes are inevitable, but the success of adjustment loans should be closer to 85 percent than 67 percent. This target could be achieved by being more selective about the environments in which donors become involved in financing adjustment.

Collier argues further that for this approach to be effective, adjustment loans need to focus on fewer, but truly important measures. (In the Dollar-Svensson sample the mean number of conditions is 46, and the maximum 193.) For such loans to be effective as a restraint, there has to be clear agreement between government and donor agencies about what is important and the grounds for nondisbursement. To be effective as a signal, loans would have to have a high success rate (say, 85 percent). They would then be accurate signals to the private sector that the government receiving the loans is seriously committed to reform.

To be effective, adjustment loans need to focus on fewer, but truly important measures.